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This is the second in a series of RPC papers on Social Security reform. The previous paper, "Rising to Meet the Challenge Social Security Poses to Younger Workers," was released January 4, 2005.

Democrats' Social Security Plan: 'The Defend the Status Quo Act of 2005'

- In the 2005 State of the Union Address, President Bush made it clear that restoring solvency to Social Security would be a top priority of his Administration. Unfortunately, Senate Democrats seem intent on opposing reform in favor of the status quo. Therefore, by opposing all change, their "bill" assures that the current system stays in place exactly as it is today. This paper "scores" their "bill," analyzing its numerous pitfalls. The paper also explores the exact nature of the problem and the need to develop a serious policy response to combat it.

- The Democrats' plan would require new borrowing or tax increases of over $5.8 trillion (in constant 2004 dollars) between 2018 and 2042.

- To cover this entire shortfall through personal income tax increases would require tax increases of an average of $232 billion a year (in constant 2004 dollars). This amounts to a 25-percent average increase over current personal income tax revenues, and a 16-percent average increase over current income tax receipts as a percent of GDP over the 25 years.

- Such tax increases would not only damage the economy, but also would disproportionately burden senior citizens. Since seniors' effective personal income tax rate is four times higher than their effective payroll tax rate, and personal income taxes account for over 70 percent of seniors' direct federal tax liability, each additional dollar of personal income taxes raised to pay Social Security benefits could simultaneously reduce retirement income by 22 cents.

- The Democrats' plan would cut benefits by between 25 percent and 32 percent and double the poverty rate among Social Security beneficiaries, forcing 875,000 additional seniors into poverty.

- Many Senate Democrats once recognized the perils of the status quo and signaled their willingness to entertain reform options. However, their willingness to speak seriously about reform has waned, even while costs of the status quo have continued to grow.

Introduction

If, as it has been said, “demography is destiny,” the future is not bright for the current Social Security system. Social Security is a pay-as-you-go system, which means the benefits of one generation are wholly financed by the taxes imposed on the generation that follows it. Thus, a generational imbalance of sufficient magnitude will leave the system unsustainable.

Such an imbalance confronts Social Security today. When Social Security was signed into law, life expectancy at birth was only 62.[1] With benefits not paid until age 65, this was a very sustainable system. Today, life-expectancy is 80 for females and 75 for males, but full benefits are paid beginning at age 65.[2] At the same time, fertility rates have declined from the post-war peak of 3.7 children-per-woman to about 2, and are expected to continue to decline.[3] This combination of factors has caused Social Security’s workers-to-beneficiaries ratio to plummet from 41-to-1 in 1945, to 3.3-to-1 today.[4] Because this ratio will continue to worsen over the entire projection period, it will burden the nation’s youngest workers with an implicit tax burden that is over 50-percent higher than the one imposed on today’s workers.[5]

Recognizing the fact that fewer workers cannot continue to support higher real benefit levels for more and more beneficiaries, President Bush has proposed strengthening Social Security to ensure its solvency. Senate Democrats disagree; they stand on the “Defend the Status Quo Act of 2005.”[6] Their bill, by opposing all change, assures that the current system stays in place exactly as it is today. This paper “scores” their “bill,” analyzing its numerous pitfalls. The paper also explores the exact nature of the problem and the need to develop a serious policy response to combat it.

Democrats’ “Status Quo” Plan: All the Foibles of Current Law

Just as with current law, workers under the Democrat plan will pay 6.2 percent of their wages in Social Security payroll taxes, with another 6.2 percent collected from their employer for a total tax rate of 12.4 percent (income subject to the tax is capped at $90,000 in 2005 and indexed for future years by wage growth).[7] In 2005, revenue from Social Security payroll taxes is expected to equal $589 billion, or 4.9 percent of U.S. Gross Domestic Product (GDP).[8]

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[1] Center for Disease Control and Prevention, “Estimated Life Expectancy at Birth,” National Vital Statistics Report [Vol. 50, No. 6], March 21, 2002. Available at: http://www.cdc.gov/nchs/data/dvs/nvsr52_14t12.pdf.

[2] 2004 OASDI Trustees’ Report. *Single-Year Tables Consistent With 2004 OASDI Trustees Report*. The full benefit age is gradually increasing and will be 67 for retirees born in, or after, 1960.

[3] The total fertility rate for any year is the average number of children who would be born to a woman in her lifetime if she were to experience the birth rates by age observed in, or assumed for, the selected year, and if she were to survive the entire childbearing period. 2004 OASDI Trustees’ Report. *Single-Year Tables Consistent With 2004 OASDI Trustees Report*.

[4] 2004 OASDI Trustees’ Report. *Single-Year Tables Consistent With 2004 OASDI Trustees Report*.

[5] 2004 OASDI Trustees’ Report.

[6] For the duration of the paper, any reference to the Senate Democrats’ Social Security plan is to be understood as current law.

[7] Self-employed individuals pay the entire 12.4-percent tax, and most economists recognize that employees pay the entire 12.4 percent through reduced wages. For information on automatic increases in the payroll tax base, see: ‘Social Security Contribution and Benefit Base,” available at: http://www.ssa.gov/OACT/COLA/cbb.html.

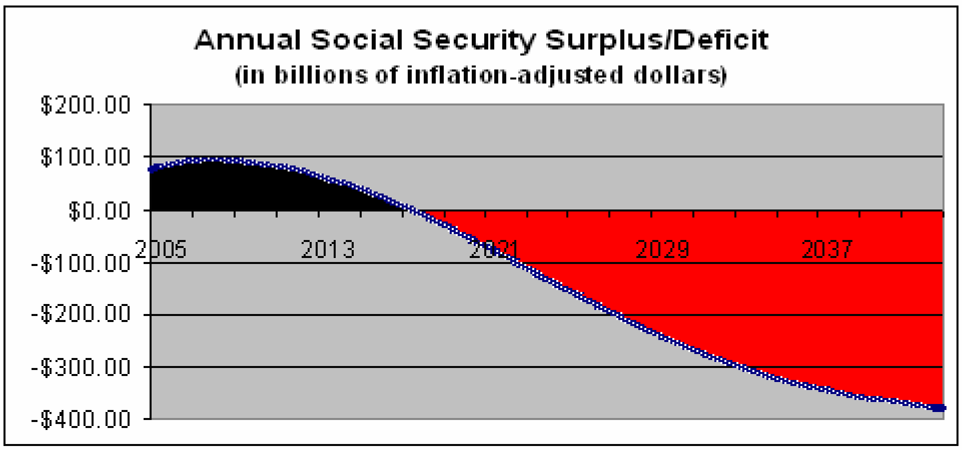
[8] 2004 OASDI Trustees’ Report. *Single-Year Tables Consistent With 2004 OASDI Trustees Report*. Nominal revenue and GDP deflated by Trustees’ CPI expectations.

Social Security Taxes and Benefits in the Near-Term

For the next 13 years, the total amount of Social Security payroll taxes collected will exceed the total amount of cash benefits paid to Social Security recipients. In fact, for the next three years, the annual difference between Social Security revenue collected and Social Security benefits paid will increase from a surplus of $85 billion in 2005 to a surplus of $99 billion in 2008.[9]

At that point, the cost of Social Security benefits will begin to escalate sharply as the baby boom generation becomes eligible to collect benefits. This will cause annual Social Security surpluses to decline until 2018 when, according to Social Security's Trustees, the program will begin to run annual deficits.[10] At first, these annual deficits will be relatively small, amounting to only $16 billion in 2018, but will increase in size each year and balloon to over $300 billion (in inflation-adjusted dollars) in 2033 (see Figure 1).[11]

Figure 1



Plan Uses Social Security Surpluses for Non-Social Security Spending

Under the Democrats' plan, during the period (2005-2018) when Social Security payroll tax revenue exceeds Social Security benefits, the resulting surplus will be used to finance other federal spending wholly unrelated to Social Security.[12] However, the Democrat plan would require the General Fund of the U.S. Treasury to keep track of the amount of payroll taxes loaned to it by issuing interest-bearing, special-obligation bonds to the Social Security

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[9] 2004 OASDI Trustees' Report. *Actuarial Tables*.

[10] Note: CBO estimates that the highest annual surplus will be $83 billion in 2009 and the program will not begin to run cash deficits until 2020. See *Congressional Budget Office*, "The Budget and Economic Outlook: Fiscal Years 2006 to 2015," January 2005.

[11] 2004 OASDI Trustees' Report, Single-Year Tables Consistent With 2004 OASDI Trustees Report. Nominal deficits deflated by Trustees' CPI expectations.

[12] Contrary to popular belief, Social Security taxes are not deposited into the Social Security trust funds. They flow into thousands of depository accounts maintained by the government with financial institutions across the country. Along with other forms of revenues, Social Security taxes become part of the government's operating cash pool. "Social Security: Where Do Surplus Taxes Go and How Are They Used?" CRS Report for Congress 94-593, September 2003.

Administration (SSA).[13] In this way, the Democrat plan commits each dollar of Social Security tax revenue to finance *both* current spending *and* future obligations.[14]

By double-counting each dollar of payroll tax revenue, the Democrat plan ingeniously lowers current unified federal budget deficits, while also providing a sizeable "Trust Fund" of assets on which to draw when Social Security begins to run cash deficits. Except that there is no money in the Trust Fund…it is merely a call on general revenues competing with all other expenses of the federal government.[15]

Unfortunately, since these special-obligation bonds are counted as both assets of the SSA *and* liabilities of the General Fund of the Treasury, they "are entered onto both sides of the government's balance sheet, or, equivalently, not at all."[16] If the Social Security surpluses were *actually* invested in real assets, the Trust Fund would represent an enormous reservoir of resources on which to draw. As a point of reference, at the end of 2003, the net assets of all mutual funds in the United States were estimated to exceed $7.2 trillion.[17] But if they are instead used to finance current spending – as the Democrats propose – the assets in the Trust Fund will represent nothing more than I.O.U.s: legal obligations to pay, not real economic resources to be tapped.

In an effort to elucidate how fictitious the prevailing Democrat treatment of the Trust Fund really is, Goldman Sachs compared Social Security to a corporate pension system:

> …Consider the case of a corporation that decided to 'fund' its pension plan by filling it with its own corporate bonds, rather than purchasing the stocks and bonds of other corporations. The accountants would never accept this maneuver because it would reduce the corporate pension plan to a mere promise by the corporation to pay its future retirees. There would be no real assets, purchased with hard cash, that could be used to back up the promise….In our view, the trust fund fiction is not just meaningless, but it has actually been damaging in terms of the public perception of Social Security.[18]

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[13] This is done in accordance with the Social Security Act Amendments of 1983 (P.L. 98-21). For information on special-obligation issues, see "Trust Fund Data," at: http://www.ssa.gov/OACT/ProgData/invest.html.

[14] Since adoption of the Unified Federal Budget in 1970, there has been no formal distinction between Social Security payroll tax revenue and other sources of federal revenue. "The Unified Budget includes trust fund receipts as income and trust fund payments as expenditures. The empirical evidence suggests that attempts to balance the Unified Budget while the trust funds were generating surpluses have led to increased government spending and personal and corporation income tax cuts within the rest of the federal government." Sita Nataraj and John B. Shoven, "Has the Unified Budget Undermined the Federal Government Trust Funds," *U.S. Social Security Administration Retirement Research Consortium*, November 2004.

[15] As Social Security payroll tax revenue has exceeded Social Security benefit payments since the mid-1980s, the Trust Fund now holds over $1.6 *trillion* in assets,[15] and will grow to over $6 trillion by 2018 if Congress pursues the Democrats' plan. 2004 OASDI Trustees' Report, Actuarial Tables. Note: in constant dollars, the Trust Fund balance is expected to peak at just over $3.8 trillion.

[16] Kent Smetters, "Is the Social Security Trust Fund Worth Anything," *National Bureau for Economic Research Working Paper 9845*, July 2003.

[17] 2004 Economic Report of the President, Chapter 6.

[18] William C. Dudley and Edward F. McKelvey, "Thoughts on Social Security Reform," *Goldman Sachs Global Economics Paper No. 120*, January 18, 2005.

Democrats' Plan Would Require New Taxes or More Debt

Under the Democrats' plan, beginning in 2018, the SSA will need to "cash in" the accumulated "assets" in the Trust Fund account to fund Social Security benefits. Since, as explained above, the Trust Fund contains no real resources on which to draw to pay benefits, Congress will need to find $5.8 trillion (in 2004 dollars) through some combination of increased taxes, discretionary spending cuts, or deficit-financing to pay off the special-obligation bonds.[19] Given the limited scope for discretionary spending cuts of the magnitude necessary to make up the shortfall,[20] this analysis will focus on potential increases in borrowing and taxes.

Increased Borrowing

Given similar demographic strains facing other rich nations, the timing of the increased borrowing necessary to fund Social Security benefits could be very expensive. Since the SSA's special-obligation bonds are already subject to the statutory debt ceiling,[21] some analysts have suggested that Congress could simply replace these special-obligation bonds with explicit, publicly held debt. In this way, the entire stock of special-obligation bonds could be raised through official borrowing with no increase in the total amount of public debt, as defined by the Congressional Budget Act of 1974.

Although the Budget Act treats publicly held debt and special-obligation bonds as equivalents, they are very different. Whereas the SSA accepts special-obligation bonds in accordance with statute, bonds issued to the public must be purchased by willing investors at market-determined interest rates. Under the Democrats' plan, the U.S. would need investors to purchase bonds at precisely the same time other wealthy nations facing similar demographic strains issue hundreds of billions of dollars of their own debt (see Table 1 on next page).

With the U.S. competing with these aging nations for scarce world savings, it is likely that the interest costs necessary to attract funds sufficient to close the Social Security shortfall will be much higher than they are currently. Many of the same nations who will be competing directly with the U.S. for savings are currently the largest holders of U.S. Treasury securities.[22] In fact, many analysts suggest that U.S. interest rates are as low as they are today precisely because these nations, particularly Japan, are saving more today in an effort to accumulate claims on the U.S. economy and make their own demographic transitions less painful.[23]

Borrowing trillions of dollars in the 2020s and 2030s, just as these nations seek to liquidate current holdings of U.S. debt, could be the most costly component of the Democrats' Social Security plan. Worst of all, increased federal borrowing at far higher interest rates would also exacerbate demographic strains on the future generations responsible for repaying that

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[19] 2004 OASDI Trustees' Report, *Single-Year Tables Consistent With 2004 OASDI Trustees Report*. Nominal deficits deflated by Trustees' CPI expectations. The nominal cumulative deficit figure is $12.95 trillion.

[20] CBO already projects discretionary spending will fall, as a percentage of GDP, from 7.7 percent to 5.6 percent over the next 10 years.

[21] Robert Keith and Bill Heniff Jr., "Legislative Procedures for Adjusting the Public Debt Limit: A Brief Overview," *CRS Report for Congress RS21519*, July 8, 2004.

[22] Major Foreign Holders of Treasury Securities, U.S. Treasury Department, available at: http://www.treas.gov/tic/mfh.txt.

[23] Michael Pettis, "Deficit Attention Disorder," *The Wall Street* Journal, Thursday, January 13, 2005.

debt,[24] and soak up savings that could have otherwise financed private-sector technology, factories, and other capital.[25]

Table 1.[26]

Wealthy Nations Will Soon Compete for a Finite Amount of Savings

	Japan	Italy	France	UK	Sweden	Canada
Peak public pension payments (% GDP)	17	16	15	6	15	10
Year of peak	2050	2035	2035	2035	2035	2035
Unfunded liabilities (Net Present Value as % of 1994 GDP)	-70	-60	-102	-24	-132	-101
Statutory retirement ages (male/female)						
1990	60/60	60/55	60/60	65/60	65/65	65/65
2020	65/65	65/60	60/60	65/65	65/65	

Tax Increases Would Target Seniors

Alternatively, Congress could elect to increase taxes, presumably taxes on personal income, to fund benefits. The Democrats' bill does not acknowledge this inevitability, but to cover the entire Social Security shortfall through personal income tax increases would require tax increases of an average of $232 billion a year (in constant 2004 dollars) between 2018 and 2042.[27] This amounts to a 25-percent average increase over current personal income tax revenues,[28] and a 16-percent average increase over current income tax receipts as a percent of GDP over 25 years (2018-2042).[29]

Economists and elected officials are well aware of the way tax increases of this magnitude would dampen economic activity. They would increase the deadweight costs associated with tax-avoidance schemes and would reduce the willingness of market participants to supply labor and risk capital.[30] But in the context of Social Security, special attention must be

[24] By comparison, the issuance of between $100 billion and $150 billion of additional debt annually over a period of 10 years to move to a sustainable system **today** "would not, in and of itself, be significant." Bond Market Association, January 25, 2005.

[25] Testimony of CBO Director Douglas Holtz-Eakin before the Senate Committee on Aging, February 3, 2005.

[26] Richard Kohl and Paul O'Brien, "The Macroeconomic of Ageing, Pensions, and Saving: A Survey," *Economics Working Papers*, 200, Organization for Economic Cooperation and Development, July 1998.

[27] 2004 OASDI Trustees' Report, *Single-Year Tables Consistent With 2004 OASDI Trustees Report*. Nominal deficits deflated by Trustees' CPI expectations.

[28] CBO. 2005 personal income tax receipts are projected to be $899 billion.

[29] CBO. 2005 GDP is projected to be $12.23 trillion. The $5.8 trillion Social Security shortfall is estimated to equal 1.23 percent of cumulative GDP between 2018 and 2042. A tax increase of this magnitude today would be equal to approximately $150 billion a year, which would increase the personal income tax take by over 16 percent as a percentage of GDP.

[30] For example, see: Martin Feldstein and Daniel Feenberg, "The Effect of Increased Tax Rates on Taxable Income and Economic Efficiency: A Preliminary Analysis of the 1993 Tax Rate Increases," *National Bureau of Economic*

paid to the way income tax increases would specifically affect taxpayers above the retirement age.

First, Democrats should acknowledge that this option amounts to shifting the financing of Social Security benefits from payroll taxes to income taxes. And making that shift would, in and of itself, disproportionately burden seniors relative to the rest of the population. This is because personal income taxes account for over 70 percent of seniors' direct federal tax liability, but only 50 percent of that liability for workers under the age of 50.[31] Moreover, seniors' effective personal income tax rate is four times higher than their effective payroll tax rate. By comparison, non-elderly families with children face *higher* effective payroll tax rates (9.7 percent) than they do personal income tax rates (9.5 percent).[32]

In 2000, seniors' income taxes accounted for 10.7 percent of total personal income tax receipts.[33] If the percentage of the personal income tax burden paid by seniors simply grows in proportion to their numbers, the share of personal income taxes paid by seniors would rise to 15 percent in 2018 and 22 percent in 2042.[34] Thus, by 2042, each additional dollar of personal income taxes raised to pay Social Security benefits could simultaneously reduce retirement income by 22 cents.

Another factor to consider is the taxation of Social Security benefits. In 2000, an estimated 39 percent of Social Security beneficiaries paid income taxes on their Social Security benefits.[35] Since the thresholds for taxes on Social Security benefits is not indexed to inflation, the percentage of beneficiaries affected by income taxes on benefits will surely rise above 39 percent as the level of scheduled benefits rises.[36] Over the next 10 years, the number of Social Security beneficiaries will rise by over 19 percent, but the total dollar value of benefits (in real dollars) will increase by over 60 percent.[37] As a result, with no changes in income tax rates, the revenues from the taxation of benefits will increase from $12.8 billion in 2004 (3.1 percent of benefits) to $32.1 billion (4.8 percent of benefits) in 2013.[38] Thus, real "bracket creep" will already erode the value of Social Security benefits even before personal income taxes are raised.

Research Working Paper 5370, November 1995. Edward C. Prescott, "Why Do Americans Work So Much More Than Europeans?" *Federal Reserve Bank of Minneapolis Quarterly Review, Vol. 28, No. 1*, July 2004.

[31] John R. Gist, "President Bush's Tax Plan: Impacts on Age and Income Groups," *Public Policy Institute*, December 2001. Direct federal tax liability is the combination of personal income taxes and payroll taxes.

[32] "Effective Federal Tax Rates: 1979-2001," *Congressional Budget Office*, April 2004.

[33] John R. Gist.

[34] 2004 OASDI Trustees' Report, *Single-Year Tables Consistent With 2004 OASDI Trustees Report*.

[35] Geoffrey Kollmann, "Social Security: Taxation of Benefits," *CRS Report for Congress RL30581*, October 30, 2003.

[36] Single filers must pay taxes on Social Security benefits if the sum of their non-Social Security income and half of their benefits exceeds $25,000 (for joint filers the threshold is $32,000).

[37] 2004 OASDI Trustees' Report, *Operations of the OASDI Trust Fund*.

[38] An additional $8.3 billion in taxes on benefits was deposited in the HI (Medicare) trust fund in 2003. This figure is expected to grow at a somewhat faster rate. 2004 OASDI Trustees' Report, *Operations of the OASDI Trust Fund. Medicare Data for Calendar Year 2003*, Center for Medicare and Medicaid Services.

Democrats Promise 25-Percent Benefit Cut

The most lamentable part of the Democrats' plan is that in 2042, after $5.8 trillion in increased taxes or borrowing, the last special-obligation bond will have been redeemed and total benefits will be cut automatically by over 25 percent.[39] Thus, the temporary injection of general revenue does nothing to sustain the system's solvency, nor is it used to finance the transition to a permanently solvent system. Instead, it simply drains $5.8 trillion from the Treasury to briefly postpone the benefit cuts that will inevitably come absent reform.

Once Social Security has exercised its last claim on general revenues, the Democrats' plan provides that aggregate Social Security benefits will be set equal to payroll tax revenue. Table 2 compares the post-2042 aggregate benefit level to that which is currently scheduled, i.e., the benefits Social Security is scheduled – but is statutorily unable – to pay.

Table 2.[40]

Year	Benefit Cut
2042	-25.4%
2052	-26.0%
2062	-27.9%
2072	-29.7%
2080	-30.9%

If the mandated benefit reduction is distributed proportionally among retirees, today's 40-year-olds will face benefit cuts of about 10 percent; today's 32-year-olds will face benefit cuts of about 25 percent; and today's youngest workers can expect benefit cuts of 30 percent.[41] Based on these assumptions, the SSA estimates that the Democrats' bill will result in a doubling of the poverty rate among Social Security beneficiaries, forcing 875,000 seniors between the ages of 64 and 78 into poverty.[42] This is because those near the bottom of the income distribution "would experience the greatest drop in their *total* retirement income because they have fewer non-Social Security resources to call upon."[43]

CBO Numbers Tell the Same Story

In an effort to make the appalling consequences of their Social Security plan appear more palatable, many Democrats argue that the assumptions made by the SSA are too pessimistic; they prefer instead to focus on the estimates of the CBO. Unfortunately, the CBO figures paint the same picture. CBO projects that Social Security will begin running cash deficits in 2020, instead of 2018, and will redeem its last special-obligation bond in 2052, instead of 2042.[44]

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[39] 2004 OASDI Trustees' Report, *Operations of the OASDI Trust Fund*.
[40] 2004 OASDI Trustees' Report, *Single-Year Tables Consistent With 2004 OASDI Trustees Report*.
[41] Andrew G. Biggs, "The Distributional Consequences of a 'No-Action' Scenario," *Social Security Administration Policy Brief No. 2004-01*, February 2004.Biggs.
[42]Biggs.
[43] Biggs.
[44] "Updated Long-Term Projections for Social Security," *Congressional Budget Office*, January 2005.

While this means that automatic benefit cuts will be postponed by 10 years relative to SSA's estimates, it would also entail far greater increases in taxes or borrowing during the interim. Instead of having to come up with $5.8 trillion in general revenue to fund benefits, Congress would have to increase taxes or borrowing by $9.2 trillion during the transition period (both figures are in inflation-adjusted dollars). And the estimated benefit cuts at the end of that period are quite similar to those of SSA: an immediate 22.4-percent cut that grows to a cut of over 27 percent by 2080.[45]

Conclusion

According to the 2004 Social Security Trustees' report, each year Congress waits to reform Social Security adds $600 billion to the cost of the problem.[46] Yet, it seems Democrats' willingness to speak seriously about reform has waned, even while the costs of failing to reform Social Security have continued to grow. It was not always this way. For example, in his 1998 State of the Union address, President Clinton declared that saving the Social Security system from ruin was his administration's top policy priority.[47] Later that year, President Clinton asserted, "This fiscal crisis in Social Security affects every generation."[48] In the following year's State of the Union, President Clinton urged Congress to put Social Security "on a sound footing" and spoke of "difficult, but fully achievable choices."[49]

Many Senate Democrats once shared these sentiments. In 1998, they even created a task force "to consider options for Social Security reform." In a release accompanying the announcement of his selection to the task force, Senator Richard Durbin (D-IL) noted the urgency: "the sooner Congress acts to avert this crisis the easier and less painful it will be."[50] Similarly, Senator Byron Dorgan (D-ND) publicly labeled "fixing Social Security" as "an urgent priority" that "ought to be at the top of both parties' agendas."[51]

Proposing only the status quo – as the Democrats do – is no solution to the problem and, in fact, would only make it worse.

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[45] "Updated Long-Term Projections for Social Security," *Congressional Budget Office*, January 2005.
[46] 2004 OASDI Trustees' Report, Section IV.B.5.a.
[47] President William J. Clinton, *1998 State of The Union Address*, January 27, 1998.
[48] "Talking Social Security to a Younger Crowd," *The Washington Post*, February 10, 1998.
[49] President William J. Clinton, *1999 State of The Union Address*, January 20, 1999.
[50] Senator Richard Durbin, "Reforming Social Security," *Congressional Press Releases*, September 15, 1998.
[51] Senator Byron Dorgan, "Fixing Social Security Must Top Both Parties' Agendas," *Roll Call*, December 6, 1999.